The role of private litigation in antitrust enforcement

Bourjade, Sylvain

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The Role of Private Litigation in Antitrust Enforcement[1]

Sylvain Bourjade

Toulouse Business School
20 Boulevard Lascrosses, 31068 Toulouse (France)
Email: s.bourjade@esc-toulouse.fr

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INTRODUCTION

There are two ways to deterring breaches of competition law. The first one consists in the threat of litigation by private parties. Private enforcement is widely used in the US where there are approximately ten private actions for each action by the public authorities. The second one is enforcement by public agencies. This is the main tool of Competition Authorities in continental Europe where very few private actions take place.

The European Commission has opened a debate on whether and how to encourage private antitrust litigation in the EU. In 2005, it launched a Green Paper entitled "Damages actions for breach of the EC antitrust rules"; then it proposes a first set of measures in a White Paper published in April 2008. The European Commission's aim to encourage private actions in Europe seems necessary and is based in part on a comprehensive study by Waelbroeck and al. (2004),[2] which contrasts the situation in the EU with that in the US. Among the main motivations of the European Commission, there are: (i) the existing obstacles to bringing private actions, especially for consumers, whose claims are small compared to the costs of bringing cases and indirect purchasers, due to the "number of layers between them and the infringers", (ii) the fact that cases may be discouraged by "information asymmetry between the plaintiff and the defendant" (but are private actions really beneficial unless plaintiffs bring information to the case?), (iii) the risk of "unmeritorious actions" (but little is said about how to avoid this except appealing to "sufficient judicial control"). Moreover, the European Commission also notes that encouraging private actions may raise issues about impact on leniency which we do not treat in our paper, but which may be taken into account as additional costs of private actions.

[1] This article is in part based on the results derived in the paper: Bourjade, S., Rey, P. and Seabright, P., 2009, "Private Antitrust Enforcement in the Presence of Pre-trial Bargaining," The Journal of Industrial Economics 57(3), pp. 372-409. The author is grateful to the Editorial Board, to Patrick Rey and to Paul Seabright for helpful comments. The usual disclaimer applies.

[2] Walbroeck, D., Slater, D. and Even-Shoshan, G., 2004, "Study on the Conditions of Claims for Damages in the Case of Infringement of EC Competition Rules," Brussels, Ashurst.

In this article, we study the effects of encouraging private actions for breaches of competition law. We also analyze how to design a private litigation system which deters anticompetitive actions without deterring legitimate pro-competitive actions.

In order to tackle those problems, we use a game theory framework. Game theory is widely used in the law and economics field. Indeed, this allows studying the strategic interaction between agents - judge, Courts, firms, potential plaintiffs and defendants - and their incentives to modify their behavior when the effective legal rules are changed. The basic idea is to consider a framework as simple as possible in order to make it tractable while keeping it the closest possible to the real world. Accordingly, we make assumptions that allow us to understand the problems we want to study. We then try to generalize the model and the conclusions in removing some of the assumptions and in sophisticating the framework. Even though we know that this abstraction does not perfectly represent the real world, it enables us to better understand the different parties' behavior and incentives which would otherwise be impossible due to the complexity of the real world.

Encouraging private actions

Encouraging private actions may be useful for a Competition Authority when private parties (customers, suppliers, competitors) reveal to the court the information they have gathered about a case and which would not be available to a public enforcer. Indeed, private enforcers may be in a better position to determine whether a breach of competition law has effectively occurred than a Competition Authority because they are, in general, better informed about their particular industry.[3] Indeed, as Shavell (1984)[4] argues:

"*Private parties should generally enjoy an inherent advantage in knowledge (...). For a regulator to obtain comparable information would often require virtually continuous observation of parties' behavior, and thus would be a practical impossibility.*"

One of the key features of private litigation is thus the use of this decentralized information. If private parties have more information than public authorities about the fact that a breach of competition law has effectively occurred, a private antitrust enforcement system should provide those firms with the incentives to reveal truthfully their private information to the court. In this case, such a system would induce potential plaintiffs knowing that a breach of competition law has effectively occurred to open a case while potential plaintiffs knowing that no breach of competition law has occurred would not. Those reforms may thus affect not only the number of private actions but also the "quality" of those actions. This issue is known in the economics literature as a screening problem. Moreover, even though interested parties only accept to reveal their private information in order to get damaged, this may help the court to punish liable firms and then to deter future anticompetitive actions. Indeed, these potential liable firms may now internalize the compensation for damages when deciding to undertake a breach of competition law.

[3] It should be noted that having information about a potential anti-competitive conduct is not always sufficient to make a successful complaint. However, an informed plaintiff may obtain the necessary evidence in going to court when discovery is available to some extent or when the burden of proof is low for plaintiffs.

[4] Shavell S., 1984, "Liability for Harm Versus Regulation of Safety," Journal of Legal Studies, 13, pp. 357-374.

Encouraging private actions in this way may however also result in excessive private actions. Moreover, this may also induce private parties to engage in "frivolous actions",[5] or at least to bring actions even when there is low evidence of a breach of antitrust laws because they are attracted to those high compensations for damages.[6] Private parties may also have incentives to open a case for other reasons that are not in line with the Competition Authority initial objective, e.g., in order to get information about a competitor or in order to reduce a competitor's ability to compete efficiently. When encouraging private actions, a Competition Authority should therefore take into account the risk associated to private antitrust enforcement when it is used strategically by private parties whose objectives diverge from the public one.

Moreover, in order to determine whether encouraging private actions is desirable or not, the goals of antitrust enforcement should be clearly identified. We could argue that a system of antitrust enforcement should be designed for two reasons: first, in order to pursue corrective justice through compensation of victims; second, to provide firms with incentives not to violate the antitrust laws in the first place through deterrence in imposing high penalties in case of violation. In this paper, we have decided to focus on the latter objective for antitrust enforcement. Indeed, as economists, we are particularly interested in examining how those reforms will modify the private parties' incentives to undertake breach of competition law or to open a case. Besides, we also wonder what could be the consequences of a strategic use of those reforms by private parties.

Then, if deterrence is the primary objective of an antitrust enforcement system, this system should prevent firms from undertaking anticompetitive actions that induce a social loss while not preventing them from undertaking actions that enhance the social welfare. In another way, an efficient enforcement system should minimize both type I errors (false positives which may avoid aggressive competition and innovation) and type II errors (false negatives which may harm competition).

THE INNOCENT'S CURSE

Private antitrust enforcement cannot be analyzed without considering the possibility of out-of-court settlements. Indeed, a large number of cases are settled and do not go to trial. For instance, using data for private antitrust cases involving firms from the US, Perloff, Rubinfeld and Ruud (1996) document that 86.6% of cases in their sample are settled out of court.[7] The fact that most private parties accept settlement offers without going to trial is not irrational, since going to trial is usually costly and time-consuming. In addition, if private actions are encouraged by the introduction of multiple damages awarded to successful plaintiffs, not only the number of cases filed should rise but also the number of out-of-court settlements. We will

[5] By "frivolous actions" we mean actions being only opened by plaintiffs in order to get damaged even though they have low evidence that the potential defendant has really committed a breach of competition law.
[6] For instance, Hovenkamp (2005) stated that a system of multiple damages may induce potential plaintiffs to open marginal and even frivolous actions. Hovenkamp, H., 2005, "The Antitrust Enterprise: Principle and Execution," Cambridge, MA: Harvard University Press.
[7] Perloff, J. M., Rubinfeld, D. L. and Ruud, P., "Antitrust Settlements and Trial Outcomes," Review of Economics and Statistics, 78, pp. 401-409.

therefore analyze here the effects of increasing the amount of damages awarded to successful plaintiffs on private antitrust enforcement, taking into consideration their impact on settlements.

Once private settlements are taken into account, encouraging private actions can lead to some strikingly counter-intuitive consequences. Most people would expect that an increase in private actions would undoubtedly lead - if it is to be effective at deterring violations of competition law - to a significant number of firms appearing before the Courts, most of whom would indeed have committed the violations alleged. However, if firms can settle out of court, and if the Courts are reasonably reliable at establishing the truth of allegations, it should be the violators who settle and the innocent firms that refuse. An effective system should therefore lead to mainly innocent firms appearing before the Courts.[8]

This result has already been documented in the literature, and we note it here so as to emphasize what is original in our results. Indeed, others have argued that pre-trial settlement may result in the innocent being disproportionately represented among the cases that go to trial.[9] We call this phenomenon the "innocent's curse". Our framework allows us to analyze its robustness with respect to a modification of the legal rules. More precisely, we show that the plaintiff will not initiate a case if the opening costs are too high. However, when these costs are low enough, the plaintiff initiates a case and a violator always settles, whereas an innocent defendant settles only when the plaintiff is "aggressive": this happens when the compensation damages are large, the prior probability of a violation and/or the quality of the judgments are important, and/or the cost of trials is limited. Thus when trial costs are large, for example, private enforcement benefits the plaintiff at the expense of the defendant, who ends up paying the same settlement compensation, whether there has been a violation or not. Private antitrust enforcement is clearly not desirable in such a case, since it has no deterrent effect on potential violators and merely transfers money from defendants to plaintiffs. Indeed, an efficient antitrust litigation system has to "screen" liable firms from non-liable ones. This objective is achieved when trial costs are lower. In this case, private enforcement helps to deter potential violators from engaging in anticompetitive behavior and allows the court to screen innocent defendants from violators, since the former go to trial while the latter accept a high settlement offer.

We also show that a modification of the enforcement rules may affect both the plaintiffs' incentives to launch a case and their incentives to behave aggressively when making the out of court settlement offers. As a consequence of our results, inducing plaintiffs to behave aggressively enhances enforcement. Indeed, the fact that plaintiffs behave aggressively makes

[8] In their paper based on a US antitrust dataset, Perloff and Rubinfeld (1987) have found that Defendants win 70% of their antitrust cases when they go to trial. Perloff J. M. and Rubinfeld D. L., 1987, "Settlements in Private Antitrust Litigation," Lawrence J. White, ed., Private Antitrust Litigation: New Evidence, New Meaning, Cambridge: MIT Press.

[9] See for instance Grossman and Katz (1983), Bebchuk (1984), Reinganum and Wilde (1986), Reinganum (1988), and Baker and Mezzetti (2001). Grossman, G. M. and Katz, M. L., 1983, "Plea Bargaining and Social Welfare," American Economic Review, 73, pp. 749-757. Bebchuk, L., 1984, "Litigation and Settlement under Imperfect Information," Rand Journal of Economics, 15, pp. 404-415. Reinganum, J. and Wilde, L., 1986, "Settlement, Litigation, and the Allocation of Litigation Costs," Rand Journal of Economics, 17, pp. 557-568. Reinganum, J., 1988, "Plea Bargaining and Prosecutorial Discretion," American Economic Review, 78, pp. 713-728. Baker, S. and Mezzetti, C., 2001, "Prosecutorial Resources, Plea Bargaining and the Decision to go to Trial," Journal of Law, Economics & Organization, 17, pp. 149-167.

possible the screening of liable from non-liable defendants which increases the costs - including potential costs of going to trial and compensation for damages - faced by liable defendants while reducing non-liable defendants' costs. This, in turn, reduces the prior incentives of firms to undertake anticompetitive actions while raising their prior incentives to undertake pro-competitive actions. Private actions are therefore only able to modify the *ex-ante* behavior of firms if they induce plaintiffs to be aggressive in the pre-trial bargaining. However, as we show below, this can be a difficult system to maintain, notably if the Courts react to the frequency of innocent defendants by making it difficult to secure a conviction, since violators will exploit this.

THE ROLE OF BACKGROUND EVIDENCE

We have seen that one should take into account the fact that private actions only help to enforce competition law when parties who have information relevant to the enforcement process are encouraged to reveal it. Indeed, if it was not the case, the Courts would do as well by opening investigations randomly. It might seem as though this implies that therefore the Court should use all the information at its disposal, and make decisions based on a fully Bayesian-rational assessment of the evidence.[10] However, we show that this intuition is false. When we allow pre-trial bargaining between plaintiffs and defendants, the deterrence effect of private actions is not only due to the fines and damages imposed by the judge to the liable parties but also to the defendants' incentives to settle out of court for large amounts if they anticipate that the judge will find them liable. When the rules of procedure are designed, we should thus not only ensure that the information generated during the trial and by the private parties is translated into an optimal decision but also ensure that those rules give the right incentives for pre-trial bargaining, because this will affect the types of defendants that will finally go to trial.

We therefore show that in order to get a more effective screening of violators from non-violators - and thus a more effective antitrust enforcement -, the rules of judicial procedure should oblige the Courts to rely solely on the facts established during the trial and not on background evidence about settlement offers. This result may seem paradoxical. Indeed, on the one hand, in order to be efficient, private actions should encourage parties to reveal their private information; on the other hand, the Courts should be prevented from using the overall available information. This implies that the Courts' decisions should not take into account what they know about the incentives for liable and non-liable firms to settle out of court. Thus, an efficient private antitrust system requires restrictions on the use of certain information by the Courts if the appropriate incentives for deterring anticompetitive and encouraging pro-competitive behavior are to be maintained. Judge Posner (1999)[11] also argues in favor of the exclusion of settlement offers from evidence:

[10] A Bayesian- rational Court is supposed to reason logically, using information about her prior probabilities - previous decisions, anticipation of the incentives and behavior of the plaintiff and the defendant… - and information available from the evidence generated during the trial, in order to reach a decision.

[11] Posner, R. A., 1999, "An Economic Approach to the Law of Evidence," Stanford Law Review, 51, pp. 1477-1521.

"*The rationale for excluding settlement offers from evidence is straightforward. Although such evidence would be relevant in showing how the party who made the offer evaluated the strength of his case and therefore how strong that case probably is, allowing the evidence to be presented at trial if settlement negotiations break down would increase the cost of settling cases and so reduce the number of settlements.*"

We go further and show that not only the content of settlement offers should be excluded but also the fact that a settlement offer has occurred or has been rejected. Out-of-court settlements can therefore have a radical impact on the results of a system of private actions, and any policy proposal needs to be evaluated with this in mind.

The literature on Bayesian reasoning by the courts makes a number of distinct points. Let us state more clearly our contributions to this literature. Friedman and Wickelgren (2002)[12] do not model settlement or litigation but point out that it is not possible to deter crime entirely when judges (or jurors) engage in Bayesian reasoning. The intuition is that a judge would never convict if she was convinced that no crime was ever committed. Our result shows something even stronger: taking into account background evidence worsens the problem, since private actions may be incapable of treating antitrust violators any differently from non-violators. Schrag and Scotchmer (1994)[13] propose another type of argument. They analyze when Courts should use character evidence in criminal trials. In their model there is no settlement. There are high crime and low crime individuals, who differ in their opportunity costs of crime. They show that under some conditions when the jury is prejudiced against habitual criminals, restricting character evidence improves deterrence (the opposite is true when there is no prejudice). Though their result has some similarities in spirit to our own, the underling mechanism is quite different. In particular our result has nothing to do with prejudice, but rather to a tension between Bayesian reasoning and the need for trial procedures to generate optimal incentives for pre-trial settlement. Fluet and Demougin (2006, 2008)[14] also show that Bayesian reasoning can have perverse effects, though for reasons that once again are quite different from ours. They consider the provision of *ex-ante* incentives to exert care in tort litigation and show that better *ex-ante* incentives are provided by not relying on evidence such as background statistics or character evidence. However, this has nothing to do with incentives for out-of-court settlement, which has no place in their model. Secondly, the nature of the evidence that should be excluded is different in their analysis: they show that litigation provides better *ex-ante* incentives by excluding evidence that is insensitive to the parties' decisions or actions, while our own result excludes evidence about the likelihood of guilt conditional on the outcome of pre-trial bargaining.

Furthermore, we are the first to our knowledge to show how such restrictions follow from considerations of optimal design of the judicial mechanism when the underlying problem consists of using the private information of plaintiffs - through the choice of cases to open and

[12] Friedman, E. and Wickelgren, A., 2006, "Bayesian Juries and The Limits to Deterrence," Journal of Law, Economics, and Organization, 22(1), pp. 70-86.
[13] Schrag, J., and Scotchmer, S., 1994, "Crime and Prejudice: The Use of Character Evidence in Criminal Trials," Journal of Law, Economics and Organizations, 10(2), pp. 319-342.
[14] Demougin, D. and Fluet, C., 2006, "Preponderance of Evidence," European Economic Review, 50, pp. 963-976.
Demougin, D. and Fluet, C., 2008, "Rules of Proof, Courts, and Incentives," Rand Journal of Economics, 39(1), pp. 20-40.

settlement offers to propose - to deter undesirable behavior among defendants while not discouraging desirable behavior. This means that we can also use our framework to show which types of cases an optimal design should encourage and which types it should discourage.

DESIGNING THE RULES OF A SYSTEM OF PRIVATE ACTIONS

We next study the optimal way to design the rules of a system of private actions and to address the issue of deterrence. We show that not all ways of encouraging private actions are equally good in terms of incentives to commit breaches of competition laws. It is better to increase damages than to lower costs of opening a case since the former weighs more on liable than on non-liable defendants. Indeed, while both tools raise the costs faced by both liable and non-liable defendants, increasing the trial costs reduces the plaintiff's incentives to be aggressive in pre-trial bargaining. Aggressiveness being the only way to screen liable from non-liable defendants, this is not desirable from an enforcement perspective. Increasing damages is therefore more effective in terms of deterrence than the fear of trial costs since the latter are more likely to discourage legitimate pro-competitive behavior. Great caution should be exercised before encouraging such actions by reductions in the costs of opening a suit as these encourage well-founded and poorly-founded cases to the same degree.[15]

Moreover, we also show that this effect is enhanced when plaintiffs have significant private information and when law is clear and Courts reliable (e.g. this is better for cartels than for Article 82/Section 2 cases). We show that it is a good idea to encourage private actions when plaintiffs' private information about wrongdoing helps to improve the decision of the court about the case with respect to the information generated during the trial. This means that private actions are useful for litigation when they don't induce plaintiffs to open "frivolous actions". Our analysis may help to shed light on the lawsuits that are undesirable in terms of the performance of the law system. We show that it is optimal to solely encourage plaintiffs with a sufficiently high quality of information about the case to launch a claim. Following this recommendation may allow the decision authority to reduce the frivolous plaintiffs' incentives to litigate without preventing genuine plaintiffs from launching a case. This result is consistent with Segal and Whinston (2007)[16] who underline that:

"*Standing to sue for antitrust violations is sometimes given not to those who suffered the most damage but to those who have the highest likelihood of being informed about potential violations. For example, the U.S. Illinois Brick case gives the standing to sue to the immediate buyers of the violators, even when they were in the position of passing on the overcharge resulting from the violation downstream to their consumers. (...) This ruling has been justified by the fact that the immediate buyers are more likely to detect violations than the downstream buyers, and so they should be given incentive to sue for these violations. The downstream buyers do not have standing to sue, even if they are the ones who were harmed the most.*"

[15] This result argues in favor of strengthening Rule 11 of the Federal Rules of Civil Procedure which is designed to combat baseless claims.
[16] Segal, I.R. and Whinston, M.D., 2007, "Public vs. Private Enforcement of Antitrust Law: A Survey," European Competition Law Review, 2007, pp. 323-332.

We then study the question of the allocation of the costs of litigation between the different parties. The most used allocations are the "American Rule" (each party pays their own costs) and the "English Rule" (the loser pays all cost). Shavell (1982) and Katz (1990)[17] show that the English Rule discourages low-probability-of-prevailing plaintiffs and encourages high-probability-of-prevailing plaintiffs. Bebchuk (1984) and Reinganum and Wilde (1986) found that the litigation rate rises with the English rule.[18] We show that it is always optimal to reimburse a defendant's costs when it is not found liable but that it may not be the case for the costs of the plaintiff because this may deter some pro-competitive actions. This implies that the English Rule may therefore not be the most efficient, as suggested by Shavell (1982) and Katz (1990), when the litigation rules allow an asymmetric allocation of the costs of litigation between the different parties.

In any case, encouraging private actions increases the litigation burden on non-liable defendants as well, even though reimbursing a defendant's costs when it is not found liable mitigates this effect. We thus introduce a compensation awarded to defendants found non-liable in order to further reduce this burden. This introduces some symmetry in the way the procedure deals with plaintiffs and defendants when they are successful. Indeed, damages for successful plaintiffs helps to deter anticompetitive actions without deterring pro-competitive actions thanks to the introduction of compensation for defendants found non-liable. Compensating winning defendants may therefore reduce the procedure's favoritism of plaintiffs, which is emphasized by Baker (2004)[19]:

"*The practical effect of mandatory trebling is to tilt the settlement process in the plaintiff's favor because mandatory trebling so inflates the defendant's cost of losing and the plaintiff's value of a victory in a rule of reason case. Is this favoritism something that we really would want to recommend to other nations for all kinds of competition law violations?*"

We then show that the optimal rules include high enough damages and compensating damages in case of no conviction. It is therefore possible to "exactly" compensate the defendant for wrong cases. More precisely, when the procedure allows successful defendants to be compensated, the damages paid to winning plaintiffs should be set as high as is required to deter all violations of competition law, and the compensation for defendants found non-liable as high as is required to ensure that no pro-competitive actions are deterred.

However, we admit that this conclusion is not very realistic. Indeed, we assume that the Courts cannot impose upper limits to the levels of fines and compensation payments. Moreover, in practice, the fines and compensations cannot be set as high as desired because of firms' limited liability, or also because of risk aversion, a phenomenon we have ignored in our model. Indeed, risk aversion means that the level of needed fines to deter anticompetitive

[17] Shavell, S., 1982, "Suit, Settlement and Trial: A Theoretical Analysis under Alternative Methods for the Allocation of Legal Costs," Journal of Legal Studies, 11, pp. 55-82. Katz, A.W., 1990, "The Effect of Frivolous Lawsuits on the Settlement of Litigation," International Review of Law and Economics, 10, pp. 3-27.
[18] Bebchuk, L., 1984, "Litigation and Settlement under Imperfect Information," Rand Journal of Economics, 15, pp. 404-415. Reinganum, J. and Wilde, L., 1986, "Settlement, Litigation, and the Allocation of Litigation Costs," Rand Journal of Economics, 17, pp. 557-568.
[19] Baker, D.I., 2004, "Revisiting History - What Have We Learned About Private Antitrust Enforcement That We Would Recommend to Others?" Loyola Consumer Law Review, 16, pp. 379-408.

actions can be lowered. However, it also means that it may be impossible for the Courts to impose a level of compensation to unsuccessful plaintiffs which exactly offsets the risk for defendants who have undertaken a pro-competitive action of being found liable. Yet, those results strongly support the introduction of compensation for defendants found non-liable in addition of damages for successful plaintiffs when private actions are allowed. Indeed, this ensures that plaintiffs only open cases for which they have a high enough probability of winning. This, in turn, raises the extent to which anticompetitive actions can be deterred and pro-competitive actions encouraged even though this is not possible in practice to prevent a non-liable defendant from bearing some risk.

CONCLUSION

Existing contributions from the Law and Economics literature have shown that pre-trial settlement negotiations may have some unexpected consequences. Starting from those conclusions, we have characterized the problem of designing a system of private antitrust actions as one of inducing the optimal use of private information of potential plaintiffs so as to discourage undesirable behavior among defendants without discouraging desirable behavior. We have shown that this optimal use of private information paradoxically requires the judicial system to disregard some information available to the Courts, and to discourage certain actions by plaintiffs who are informed but not informed reliably enough. We hope that our analysis of the effect of various parameters of the judicial process - such as fines, levels of legal costs and the costs of opening a lawsuit - will provide useful guidance for the design of systems of private anti-trust actions, and that our proposition for more symmetric incentives - notably for successful defendants' compensation - will help in finding a better balance between the needs for deterring anticompetitive actions while not discouraging pro-competitive behavior. It is this need for balancing deterrence requirements that truly distinguishes the analysis of antitrust litigation from the more general area of the economic analysis of legal procedure.

From those results, we can draw some simple policy conclusions. First, encouraging private actions is only useful for a Competition Authority when violators and non violators defendants are not treated alike and when potential plaintiffs have significant private information on the fact that the defendant has indeed committed a breach of competition law. Moreover, when it is desirable to encourage private actions, it is better to do so by increasing damages paid to successful plaintiffs than by lowering the costs of opening a case since the former weights more on liable than on non-liable defendants. In addition, the costs imposed by private actions to non-liable defendants may be attenuated by the introduction of compensation paid by unsuccessful plaintiffs to winning defendants. Finally, the rules of judicial procedure should constrain the Courts to rely solely on the facts established during the trial and not on background evidence about settlement offers.

An interesting extension would consist in analyzing the impact of class actions - including the effects of conditional contracts for the lawyers - on the efficiency of a private antitrust system. However, this issue goes substantially beyond those raised in this article and is left for future research.